THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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Beyond Recovery

> **"If a government perseveres in borrowing to pay the interest of former loans, that interest and with it taxation also must go on increasing to infinity. It is impossible to avoid a precipice, when one follows a road that leads nowhere else."**
>
> **A Treatise on Political Economy**
> **Jean Baptiste Say, 1880**

A NOTICE TO OUR READERS:

With this issue, we are making several improvements in the appearance and administration of this letter. As can be seen, it now has a new name: *The Richebächer Letter, Monthly Analysis of Currencies and Credit Markets.* This will be published by a new company, The Richebacher Letter, Inc.

In addition, we have moved our subscription services to the United States, and now offer full telephone service for orders and inquiries. We hope this will allow us to better serve our readers, particularly our U.S. subscribers. To our long-time readers, we would like to take this opportunity to thank you for your support and encouragement over the years.

Recent events in U.S. and world financial markets obviously are a bittersweet vindication of our persistent warnings that the global financial bubble which has developed over the past few years must eventually burst. That process, we would say, now is well underway.

Still, we are struck by the general composure with which the bond crash is regarded by the financial community. In our view, this reflects nothing more than a stubborn self-deception about the cause of the crash and consequently about its harmful implications.

While the bond crash took the financial world completely by surprise, the experts have hurried to explain it away. For the most part, they dismiss it as a transitory event of relatively minor economic and financial importance.

This conventional interpretation also mischaracterizes the causes of the crash. It is attributed partly to misplaced inflation fears, and partly to a natural, though temporary, response to the global economic recovery and the Fed's switch to monetary tightening.

Implicit in this is a comforting, if naive, faith in the Fed's ability to control events. Having garnered widespread applause for stabilizing the U.S. banking system in the early 1990s, the Fed now collects praise for preemptively moving to counter emerging inflationary pressures. With such a powerful and perceptive central bank in control, it's only a question of time before the big bond rally takes off.

We, on the other hand, regard this soothing story as so much nonsense. For millions of investors around the world, the 1994 bond crash was every bit as traumatic as the stock market crash of 1987. The Securities Industries Association – the main trade group for U.S. brokers – calculates that paper losses from the U.S. bond crash amount to at least $1 trillion, not counting further huge losses in the derivatives market. This roughly equals the $1 trillion loss generated by the 1987 stock-market crash.

The big difference: The 1987 stock crash instantly became a huge story in the mainstream news media, while last year's bond crash made headlines only in the financial press.

To a certain extent this reflects the contrast in timing. The 1987 crash unfolded in a few short days. The 1994 crash, on the other hand, stretched over weeks and months. But we think the current relaxed attitude also reveals a widespread complacency about the long-run effects of even the severest market setbacks.

This view probably stems from the aftermath of the 1987 crash, when stock prices quickly recovered and moved to new highs. More to the point, 1987 strengthened the belief in an omnipotent Fed, one capable of fending off a true, irreparable crash. Deeply etched in Wall Street's memory is the terse, one-sentence statement issued by the Fed on the morning of October 20 – the day after Black Monday. "The Federal Reserve," it read, "consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system."

In popular lore, this pronouncement was a sign the Fed was ready to start passing out checks – not just to the banks, but to any financial institution caught short by the crash. The statement is given much of the credit for calming the panic before it snowballed into a system-wide meltdown. It also spawned a consensus view that any future crisis could and would be resolved the same way, with an unlimited and unconditional Fed commitment to support any institutions in trouble.

The truth behind the myth is far less comforting. The Fed's rescue actions in the days following Black Monday actually consisted entirely of providing the banks with excess reserves, in hopes they in turn would provide loans to brokers and investors struggling to avoid default. But amidst the general panic, banks proved extremely reluctant to lend to threatened institutions. Only through frantic pleas and pressure tactics were Fed officials able to coax the banks into extending the desperately needed credits.

The true lesson of 1987, then, is that the Fed cannot stem a systemic crash alone. It must rely on the banking system to provide the necessary liquidity – no easy task when asset values are crashing all around.

WORSE THAN '87

Consensus opinion also overlooks another crucial point: The 1987 stock crash actually was a relatively narrow affair. The critical liquidity problems were confined to market makers in stocks, that is to say, to a limited number of specialists, brokerage firms and risk arbitragers who suddenly faced heavy selling by retail investors on the one hand, and sizable margin calls by their lending banks on the other.

In hindsight, this can be seen as a mini-crisis, requiring a minimal rescue operation to bail out a minimal number of institutions over a minimal number of days, and involving a minimal amount of actual emergency lending. There was more drama to the spectacle than anything else.

Precisely the reverse is true of the present bond crash. While the decline in bond prices *appears* relatively unspectacular, it has far wider implications for the U.S. financial system and the economy. To start with, there are about $9 trillion in bonds outstanding, triple the total stock-market capitalization. Everyone holding bonds has been hurt, the size of the losses depending on the type and maturity of the bonds owned. But on average, bonds have lost more than 10% of their market value since the beginning of 1994, ranging from a 5% loss on one-to-three year Treasuries, to more than 20% on 30-year Treasury bonds. Losses on structured notes and other leveraged instruments have been far worse.

If bond prices fail to recover substantially, there will be serious consequences for the funding of U.S. pension plans as well as the projected payout and future premiums of the insurance industry. Governments at all levels will face soaring debt-service costs, boosting their budget deficits. A particularly hard case is the U.S. securities industry, especially the large Wall Street investment banks. During the early 1990s, they were both the cheerleaders and the

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (December 27)	12-Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. Mos. Lo
Australia	0.0%	-12.2%	-10.2%	-22.6%	3.7%
Canada	2.3%	-3.0%	-2.2%	-9.0%	5.9%
France	0.5%	-13.8%	-14.1%	-20.4%	7.2%
Germany	2.7%	-7.1%	-6.6%	-7.3%	7.4%
Hong Kong	-4.0%	-30.1%	-28.2%	-31.8%	7.8%
Japan	5.6%	13.2%	17.2%	-8.5%	17.2%
Mexico	-8.4%	-12.5%	-12.2%	-21.0%	16.3%
Spain	-6.3%	-14.6%	-15.0%	-22.4%	0.0%
U.K.	1.6%	-9.8%	-10.9%	-12.4%	7.2%
U.S.	2.3%	-0.9%	-1.7%	-4.1%	5.4%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (December 27) (%)	Current Rate	12-Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. Mos. Lo
Australia	10.19	-13	351	357	-52	382
Canada	9.08	4	245	251	-36	274
France	8.05	11	241	240	-38	244
Germany	7.47	19	194	184	-29	194
Japan	4.55	-11	124	128	-41	129
Spain	11.59	49	358	345	0	389
U.K.	8.49	7	239	240	-54	240
U.S.	7.76	-15	197	207	-27	219

Exchange Rates

Versus U.S. Dollar, % Change

Country (December 27)	Current Rate	12-Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. Mos. Lo
Australia ($)	1.29	2.2%	14.0%	14.0%	0.0%	14.6%
Canada ($)	1.40	-1.5%	-5.1%	-5.1%	-6.4%	0.0%
France (FF)	5.44	-1.6%	8.8%	6.4%	-6.3%	9.9%
Germany (DM)	1.58	-0.9%	10.4%	8.0%	-5.4%	12.0%
Japan (Yen)	100.4	-1.6%	11.4%	11.0%	-3.7%	12.6%
Spain (Pta)	133.4	-2.5%	7.3%	4.6%	-7.1%	9.0%

quarterbacks of the carry-trade game – the spectacularly lucrative business of playing the yield curve with heavy debt and derivatives leveraging. In addition to taking huge bond positions in their own accounts, the Wall Street houses persuaded their clients to join in the fun.

All of these bond purchases were financed with cheap short-term debt, primarily through repurchase agreements, or repos. This boosted the industry's total liabilities to about $1 trillion – equal to nearly one-third the balance sheet of the entire U.S. banking system.

REPO MADNESS

In its understated way, the International Monetary Fund has taken note of this repo explosion. In a recent report on the global capital markets, it had this to say:

"The key consideration...is the ease with which market participants can finance their securities positions. The most common financing vehicle is the repurchase agreement (repo). The standardized, short-dated repo is becoming the main instrument for position funding in the major markets. It facilitates the taking of leveraged positions in securities.

"The largest repo market is, not surprisingly, located in the United States. In October 1993, primary dealers alone had open repo contracts in government securities of $852 billion, equivalent to 30 percent of U.S. marketable debt outstanding."

As the IMF correctly observes, during the bubble years repos became the instrument of choice for investors wishing to build securities positions many times larger than their available equity. Working through specialized market makers, these speculators found nonbank lenders (such as corporations, insurers, or money-market mutual funds) who had excess funds to invest on a short-term basis.

The process works like this: The leveraged speculator sells his bonds to the lender, who pays him the borrowed sum against delivery of those securities. But at the same time, the speculator agrees to repurchase the securities the next day at a slightly higher price. The difference between the sale and repurchase price constitutes the interest to the repo lender. In short, repos are overnight loans secured by bonds. They've been described accurately as nothing more than a form of "glorified pawnbroking."

The explosive growth of U.S. repo markets – and the salutary effect on bond prices – has not gone unnoticed in the world's other financial capitals. Apparently inspired by the "superb" U.S. experience with repo financing, the Bank of England recently announced its decision to facilitate the leveraging of British gilts by creating an open market in repos. Until now, only market makers have been permitted to finance their inventories in this way. In the future, anyone will be able to do so.

We find it hard to believe that any central bank would find this an opportune moment to open the spigots for still more reckless speculation. Indeed, the Bank of England's decision is quite appalling, in that it shows a complete lack of understanding of the dire consequences of heavy financial leveraging. As the markets just now are demonstrating, every repo bubble – that is to say, every scheme to use short-term debt to finance purchases of longer-term securities – is doomed to burst. There always comes a day in the business cycle when short rates catch up with long rates, forcing speculators to the wall.

That's precisely what has happened to the global army of leveraged debt holders since the Fed's first rate hike. Almost any yield-curve play they entered into during the great 1991-93 bull market in bonds now is underwater in three different ways:

- The steep fall in bond prices has left them with huge capital losses, in some cases equalling most or all of their original equity.

- The crash has sharply curtailed trading activity, making it difficult or impossible to exit large positions without suffering even larger losses. Liquidity has vanished, especially for some of the more exotic derivatives.

- Sharply higher short-term interest costs now exceed the yields on their bond holdings. The losses created by this negative spread are gradually eating up whatever cash reserves the speculators have left.

This last development is the most serious, since it can push leveraged players into forced liquidation, with disastrous results for the market as a whole. The Fed's 75- basis-point rate hike in November appears to have had exactly that effect. One spectacular victim: Orange County, California, which suffered losses in excess of $2 billion on its highly leveraged bond portfolio.

HOBSON'S CHOICE

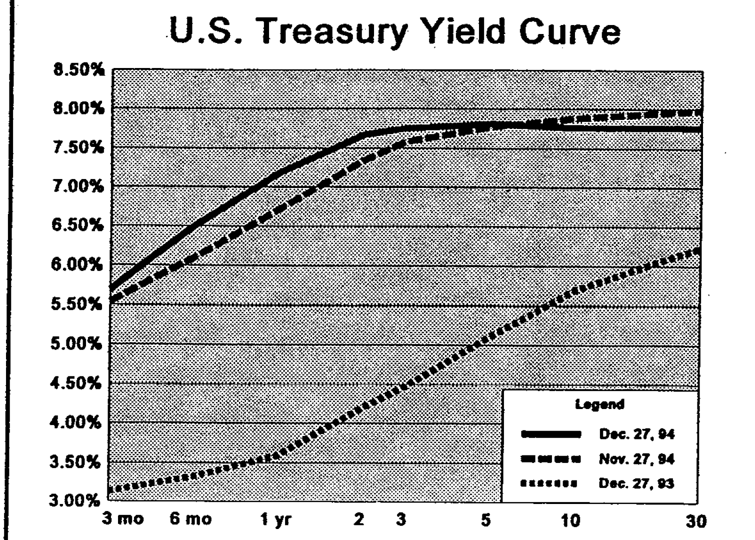
Given these conditions, speculators face a sickening choice: They can sell out and stop their losses, or wait in hopes of an eventual bond rally that will make them whole. This is widely expected to happen later this year, once the Fed has finished its round of rate hikes.

We, however, are at a loss to see where the necessary buyers will come from to fuel this much-awaited rally, considering the entire U.S. financial system is chronically overleveraged and short of cash. Having depleted their cash holdings through their frantic race into bonds and stocks, U.S. financial institutions simply do not possess the liquidity to fuel a renewed bull market.

Selling, on the other hand, only aggravates the general liquidity crunch. As a result, the yield curve itself is being bent into a highly unusual shape. The spread between the federal funds rate, now at 5.5%, and the two-year Treasury note has widened. At the longer end, however, the curve has flattened dramatically. The spread between the 2-year and the 30-year Treasury has narrowed to a mere 9 basis points, from 211 at the start of the year.

Never in history have the short and long ends of the yield curve moved along such radically diverging paths. Yet only a handful of observers have drawn the correct conclusions from this fact.

Some misguided analysts focus on the recent modest rally at the long end, which has pushed the yield on the 30-year bond back below 8%. This is taken as a sign the bear market is nearing its end.



Source: Federal Reserve

But the long end is hardly the right measuring stick. For one thing, it's a relatively small fraction of the total market. Outstanding Treasury bonds maturing in 20 years or more total $328 billion – just 12% of all Treasury debt held by private investors. In such a relatively small market, even a minor uptick in buying can have a powerful effect on prices and yields.

Other analysts look at the flat yield curve beyond the 2-year Treasury and see it as evidence that Fed policy has turned exceedingly tight – perhaps too tight. Still others point to the extraordinary steepness at the short end of the curve, and warn the Fed remains far too easy.

We think these conflicting views all miss the crucial point. To us, the yield curve's bizarre slope is a clear sign of the immense strains building in the U.S. financial system – pressures the Fed is quite helpless to relieve.

The dramatic flattening in the longer end of the curve does indicate extreme tightness, but despite Fed policy, not because of it. The popping of the repo bubble is the real culprit. As market participants unwind their repo positions, the net result is an increase in the supply of bonds and a corresponding decrease in the supply of funds available to support bond prices. Deleveraging works just as wonderfully on the downside as leveraging does on the upside.

The scramble to exchange repo paper for cash – that is to say, for bank deposits – is fueling a contractionary chain reaction. To obtain cash, repo borrowers must sell their bonds. But to purchase those bonds, some other market participant must be willing to part with cash. This, in turn, reduces his liquidity. As bond prices fall, more loans are extinguished. Liquidity contracts even further.

This deleveraging process operates in much the same way as when the Fed pulls reserves from the banking system, forcing a multiple contraction in bank loans and investments. The primary difference: A contraction in repo lending has no direct effect on the monetary aggregates, since it works upon the vast pyramid of *nonbank* credit created to finance bond speculation. But the result looks and feels very much like a period of extreme monetary restraint – in other words, like a severe Fed tightening. The most ominous parallel to the current situation is the bursting of the broker-loan bubble in 1929, which brought on the Great Crash.

In truth, Fed policy actually remains quite loose, at shown by its willingness to hold the federal funds rate far below nearby market rates. Why does this not alleviate the general liquidity crunch? Because having pricked the financial bubble, the Fed cannot control the consequences. It can hurt – by raising short-term rates, it can force still more overleveraged speculators to unwind their positions. But it cannot help. Liquidity creation in the market now depends not on the Fed, but on the willingness of repo lenders to lend and bond speculators to borrow. Understandably, both groups have turned cautious. Deleveraging, not speculating, is the new order of the day. As far as the bond market is concerned, the Fed is pushing on the proverbial string.

This brings us to the overriding issue, one we have consistently focused on in these letters: The potentially disastrous liquidity trends at work in the United States. To prevent an extended bear market in bonds and stocks, the system needs liquidity – real liquidity, the kind provided by an expansion of bank credit. Only this can counteract the catastrophic deflation now underway in the bond market.

Yet the U.S. national "money machine" – the banking system – has virtually ceased to manufacture liquidity, as reflected in the protracted, extraordinary weakness in the money supply. Since the end of 1989, U.S. broad money growth has risen by $180 billion, or 4.4%. But most of this growth – $125 billion – reflected a sharp rise in currency in circulation. The greater part of this increase disappeared into the international drug market and other foreign black markets. It added nothing to overall U.S. liquidity.

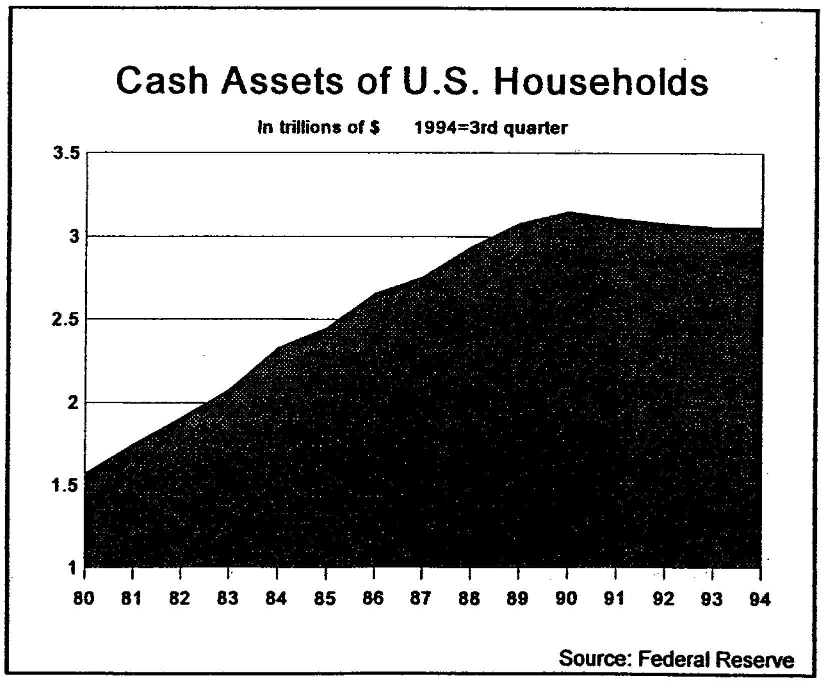
In isolation, this weakness in money growth may not appear alarming. Many conventional analysts even seem to regard it a virtuous achievement in the fight against inflation. What they fail to see is that this minimal liquidity creation actually was accompanied by rampant debt creation. Since the end of 1989, total debt, as recorded in the Fed's flow-of-funds accounts, has expanded by some *$4 trillion.*

That's not even the full story. The Fed's figures don't cover the bulk of the huge debt and derivatives leveraging that has taken place in the repo and futures markets, outside the normal flow of funds, running into more trillions of dollars.

The legacy of this unbelievable frenzy of leveraging is an enormous pyramid of debts and financial assets, balanced on a relatively narrow base of bank deposits – i.e., of money. By its very nature, such a financial structure is extremely vulnerable to any disruption in money flows.

THE U.S. CONSUMER AT BAY

U.S. household balance sheets, too, are vulnerable as never before, due to the mass stampede into debt and illiquid securities during the early 1990s. In 1993, U.S. consumer income grew by $221 billion, but debt grew by $294 billion. This pushed the debt-to-income ratio to by far its highest level in history. Yet, consumer spending increased by just $218 billion. In the first three quarters of 1994, consumer spending rose by $201 billion, while income grew by $246 billion and debt rose by $230 billion.

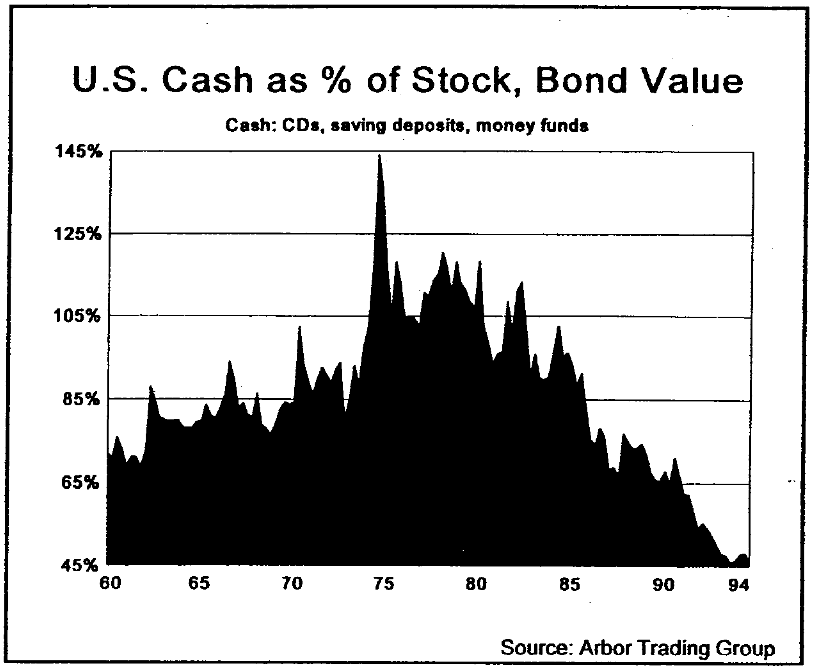


Looking at these figures, we have to wonder where all the borrowed money has gone. More importantly, we wonder how long this inordinate borrowing binge can continue, considering that interest costs have soared.

But record-high borrowing and soaring interest payments are only part of the U.S. consumer's financial predicament. His long-standing debt problems now are being compounded by rapidly deteriorating wealth and liquidity.

We see three culprits: Record-low holdings of bank deposits and other liquid assets; record-high holdings of stocks, bonds and

other marketable securities; and falling prices for those securities, with even bigger declines looming on the horizon.



In 1980, more than half of the financial assets held by U.S. households consisted of bank deposits and CDs. Equities accounted for roughly one-third, while bonds made up 11%, and mutual fund shares just 4%. Since then, bank deposits have plunged from 53% to just 33% of total assets. In absolute terms, deposit holdings peaked at $2.7 trillion in 1988, and have been flat for the last seven years. Meanwhile, stocks and mutual funds have doubled from $2 trillion to $4 trillion, in part due to capital appreciation, but primarily due to new purchases. As a share of total assets, mutual fund holdings have quadrupled to 16%, while bonds have risen from 11% to 18%. Equity holdings have remained relatively constant, at one-third of total assets.

The message of these figures is crystal clear: The American consumer is caught in a scary trap. The long decline in his liquid assets, measured as a percentage of U.S. stock- and bond-market capitalization, has accelerated sharply in the 1990s. But the roaring bull markets in stocks and bonds, which masked his rising indebtedness with powerful wealth effects, has faltered. For the first time in more than a decade, he is faced with falling financial asset prices, threatening to wreck both his wealth and his liquidity. For the first time in the entire postwar period, consumer net worth – asset values minus debts – is in a substantial, protracted decline.

LOOKING FORWARD

So much for the past and present. What about the future? What can investors expect to see in 1995 – the bull market's revival, or a prolonged, severe bear market? We are absolutely certain it will be the latter, owing to the intractable nature of the unfolding U.S. liquidity crunch.

Conventional analysts worry the Fed's rate hikes to date have been insufficient to slow U.S. economic growth. Yet they were sufficient to devastate global bond markets and to slash instantly the former buoyant money flows into the financial markets. This fact is generally played down with the argument that everything depends on the course of the real economy, and the economic impact of future Fed moves. As growth now seems excessively strong, inflation is seen as the main threat.

We think conventional wisdom puts the cart before the horse. We expect the financial markets to drive the real economy, not the other way around. The popping of the U.S. financial bubble has set in motion powerful deflationary forces that are spreading throughout the financial markets. Ultimately, these forces also will deal a mortal blow to the current U.S. economic recovery. At best, an extremely hard landing is unavoidable. At worst, the United States could face an asset deflation spiral of historic proportions. It is this alarming prospect – not some illusory inflation threat – that should preoccupy investors at this critical time.

The most important point to note about the U.S. liquidity picture is the Fed's chronic, persistent failure to provide new liquidity to the economy – as evidenced by the stagnation in broad money growth. Yet this indisputable fact

has been widely ignored, in large part because of the great boom in the financial markets, which seemed to provide ample evidence of excess liquidity creation on a monumental scale.

Normally, this would be true. As a rule, bull markets are associated with rapid monetary growth. Yet there have been rare exceptions, and the recent financial bubble was one. What buoyed the financial markets in the early 1990s was not excess liquidity, but rather an unprecedented *flight* from liquidity, combined with equally unprecedented financial leveraging, and stagnant deposit creation by the banks. The result was record low and shrinking bank liquidity – as seen in the monetary aggregates.

Such sharp declines in liquidity always prove disastrous whenever a leveraged bubble is pricked and individuals try to move back into cash. This has been our warning for a long time now. Nevertheless, a sizable body of opinion continues to insist the Fed is expanding credit in a wildly inflationary manner. The key pieces of evidence cited are the persistent, double-digit increases in the narrowest definitions of money – Federal Reserve credit and the monetary base. These directly reflect the Fed's open-market purchases of U.S. Treasury securities. For this reason, a certain school of American monetarists traditionally has regarded them as the best indicators of Fed policy.

THE MONETARY MUDDLE

This much is true: The Fed has been, and still is, a regular, heavy buyer of U.S. government securities, running at an annual rate of roughly $30 billion in recent years. But there is something new and unprecedented about these purchases. In the past, most of the "high powered" dollars created by the Fed went into bank reserves, triggering multiple rounds of credit and deposit creation. In this way, the supply of liquidity, or broad money, increased by a factor many times larger than the rise in high-powered money.

But this is precisely the process that has broken down almost completely in recent years. As we noted earlier, the Fed's outsized bond purchases reflect nothing more than the sharply increased demand for U.S. currency both at home and abroad. This is a function both of the size and prosperity of the international narcotics trade, and the emergence of the dollar as the chief "parallel" currency in the former communist countries.

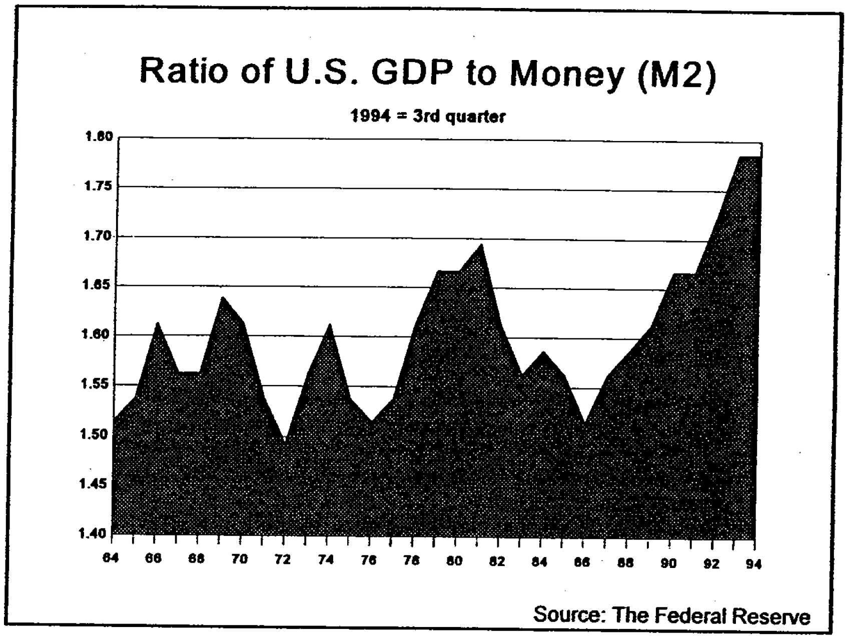
Federal Reserve credit to the banking system, on the other hand, actually has declined over the past year, to $25.1 billion from $29 billion a year ago. Yet during the same time, banks expanded their total loans and investments by some $215 billion. By any traditional measure, the banks have been facing extremely tight liquidity conditions. But this hasn't stopped them from falling all over each other to lend money to consumers and corporations at steadily shrinking net interest margins.

What in the devil is going on here? In brief, U.S. banks increasingly are acting like their nonbank competitors. That is, they are funding their loans and investments not through deposit creation, but rather by borrowing in the capital and money markets. The net result is even more reckless leveraging of the existing liquidity base, but this time inside the banking system, rather than outside of it.

We need to be clear on this point: The alarming shrinkage in bank liquidity over the past year has *nothing* to do with any Fed tightening. The Fed continues to do what it always does in a period of ease: It is setting arbitrary interest-rate targets, and then supplying whatever reserves are needed to maintain those targets and allow banks to meet their reserve requirements. Thus, as we mentioned earlier, the Fed's stance remains quite loose.

The real story here is that the banks' reserve requirements themselves are declining. Why? Because the one category of deposits subject to such requirements – demand deposits – is shrinking, while the total deposit base is stagnating. This is the central fact behind the weakness in the money aggregates.

How can the banks finance lending without deposit growth? As we have explained in past letters, their largest funding source over the past year has been the Euromarket, where they have increased their borrowings by more than $100 billion, to $222 billion. U.S. nonbank lenders, such as the Federal Home Loan Banks, also have been key financing sources. Most of this debt, in turn, has been converted into bonds or asset-backed securities and sold into the markets.



All in all, it's hard to imagine a more confusing monetary mixture. But the key fact is that all of this borrowing and lending activity has added nothing to the existing U.S. money supply. It merely has piled another layer of debts and assets on the giant pyramid of leverage that is the U.S. financial system.

The problem: The deflation of the bond bubble is systematically squeezing the banks, as well as the financial institutions – like the FHLB and the other big federal mortgage agencies – that they rely on for funding. The crash has left all of them saddled with massive amounts of deflated long-term assets, and equally massive amounts of short-term debt that soon will have to be refinanced at significantly higher rates. The fact that much of this short-term debt has been swapped into fixed-rate debt doesn't change the overall picture: It merely shifts the problem to others, exposing the big institutions to the risk of counterparty default on a grand scale.

Faced with this looming squeeze, many banks have chosen to meet their liquidity needs by running down their huge bond portfolios. Since July, bond bank holdings have fallen by some $31 billion. That this primarily involves a sharp decline in the purchase of new Treasury bills and notes, rather than the sale of existing securities, also matters little. The net result is to further tighten the liquidity squeeze in the bond market, driving up yields and worsening the pressures mounting throughout the entire financial system.

As long as banks remain reluctant to expand their deposits, there's little the Fed can do about this dangerous situation – even if it wanted to. Stagnant deposit growth means unchanging or even shrinking reserve requirements. This, in turn, means little or no demand for injections of liquidity by the Fed, aside from those needed to offset the steady drain of currency out of the country.

So far, the Fed shows not the slightest sign it understands the gravity of the problem, despite the growing number of financial calamities. To that list, we now must add Mexico, as well as the hedge funds and other speculators who gambled heavily in the Mexican markets. Last month's 40% peso devaluation dealt them staggering overnight losses.

Conventional wisdom blames this setback on the country's simmering political problems. We see it as just another symptom of the global liquidity squeeze created by the bond crash. Overall, private capital flows to the emerging markets fell 14% last year, to $160.6 billion, from 1993's record $186.8 billion, according to the Institute of International Finance. Mexico, with its giant current-account deficit, was most vulnerable to this abrupt decline.

This also has direct consequences for the U.S. markets. During the bubble years, central banks in the emerging countries absorbed billions in capital inflows from the United States. Even Mexico, a debtor country, accumulated

record high dollar reserves. What did these banks do with their dollar holdings? For the most part, they invested them in shorter-term U.S. Treasuries. But now, as foreign investors withdraw, they are compelled to sell these holdings to obtain the dollars needed to support their own currencies. Mexico, for example, is reported to have sold over $6 billion in Treasuries in the week leading up to its devaluation. These sales have aggravated the extreme liquidity squeeze in the front end of the yield curve.

LOOKING AHEAD

In trying to appraise the outlook for the financial markets in 1995, three questions are uppermost in our minds:

- How big is the overhang of debt-leveraged bond positions that are underwater and have yet to be unwound?
- What are the implications of the rise in short- and long-term interest rates for the U.S. stock market?
- Can the Fed once again put things right, as it did in 1987?

As to the size of the overhang from the bubble, we think it is still immense. Unfortunately, there is no statistical evidence to shed light on this question. But anecdotal evidence suggests the remaining speculative positions still total well in excess of $1 trillion. Liquidation of these impaired positions requires liquid buyers. These do not exist in anything like the numbers necessary to ward off a catastrophe.

Rescue from this dire predicament can only come through massive bond purchases by the banks. Not only would these directly support the market, but if financed through renewed deposit creation, they also would relieve the general liquidity drought. But having said this, we hasten to add that there is no chance of it actually happening. U.S. banks themselves are far too overloaded with bonds that they wish to dump. Far from adding to the system's liquidity, they are busy decreasing it by selling bonds.

So far, only the most horribly leveraged, most vulnerable players – like Orange County – have been forced out of their positions, largely by margin calls from their lenders. The banks, the brokers and the big federal mortgage agencies, while also loaded to the gills with illiquid bonds, are trying to ride out the storm. They are relying on the much-anticipated bond rally to bail them out over the coming year. But for this very reason, we think any rally that does materialize will be overwhelmed by heavy selling.

In our view, the surviving leveraged players pin their hopes too much on a cooling in inflationary pressures as the economy slows this year. This may well happen, but it still would have little bearing on the fundamental problem. In the end, it always comes down to the laws of supply and demand. In 1995, we see the potential for record supply, consisting of new bond issues and the continued liquidation of leveraged accounts. We don't see potential buyers.

The deluge of money that so swamped the global financial markets in the early 1990s came from completely spurious, speculative sources. These have largely ceased. The markets once again must depend on the flow of available current savings. For countries with very low domestic savings rates and big government budget deficits, such as the United States, this spells disaster. Relief can come only from renewed buying by banks and foreigners. As we see slight odds of this happening, we must conclude that the bear market in U.S. bonds will continue in 1995.

What are the implications for equity markets? The bull story says stocks can still rise in 1995 despite higher interest rates, because of healthy earnings growth generated by a coordinated world recovery. Leaving aside the implausibility of that economic scenario, we have to return to our basic question: Where are the potential buyers?

It is widely accepted that the great stampede of U.S. individual investors out of bank CDs and into equity mutual funds was instrumental in driving the bull markets in both U.S. and global stocks. The motive for this massive shift also is undisputed: It resulted from the long period of rock-bottom short-term rates fostered by the Greenspan Fed. With the Fed's rate hikes, this impetus has been removed. While the federal funds rate still appears artificially low, it almost has doubled over the past 11 months. Yields on short-term Treasuries have climbed even more dramatically. A one-year bill, which yielded just 3.58% last February, pays almost 7.20% now.

Higher yields already have stopped and even reversed the flow of money out of CDs and into equities. This alone has been sufficient to break the bullish trend in stocks. Continued inflows from individual pension plans – many of them funded through automatic payroll deductions – coupled with a sharp drop in new public offerings, have helped ward off a drastic plunge. But the market's overall condition is steadily deteriorating, despite the strong Dow. This can be seen in the steep drops in some of the broader market averages. We are looking for the climactic event that will spur the stampede of investors out of stocks and into cash. It could come this year, when a sharper-than-expected slowdown in the economy signals the coming landing will be hard rather than soft.

THE HELPLESS FED

This brings us to the final, crucial question: Can the Fed put things right? We seriously doubt it.

Right now, markets remain relatively optimistic that the Fed will bring the U.S. economy in for a soft landing. By cooling inflation and inflation fears, this is supposed to pave the way for lower interest rates and the resumption of the bull market, both in bonds and stocks. We, on the other hand, think the Fed has lost control of U.S. liquidity trends. Accordingly, we expect the current slump to develop into a prolonged bear market.

Our conclusions reflect our fundamentally different forecasting approach. The bulls concentrate on trends in the real economy, particularly the inflation outlook. We focus on developments in the financial markets, particularly changes in portfolio flows between cash and securities.

Our starting point, as we have so often explained, is the fact that the recent financial boom was overwhelmingly driven by leveraging, and by a mass flight out of money and into securities. If this had supported spending on goods, services and tangible assets, the resulting price rises would have been called inflation. But because the money deluge inflated the prices of securities, it was hailed as a healthy bull market.

What's wrong with leveraging financial assets in this way? First, it can't last. Second, it leaves behind an increasingly fragile financial structure. Eventually, there comes a breaking point where the artificial flows slow down and then reverse. Even modest interest-rate hikes can prick the bubble in this fashion, by instantly reversing the speculative leveraging.

While higher rates may not yet have dented consumer borrowing, they have fundamentally changed the conditions that determine portfolio flows. The main engine of the bull market has sputtered out. As more investors come to realize the boom is over, the shift back to cash will accelerate. Once it sinks in that there isn't nearly enough cash to accommodate every seller at current price levels, the shift will turn into a stampede. The crash will arrive.

Right now, there is a widespread view that this can't happen, and that, even if it did, the Fed would prevent a system-wide meltdown, as it did in 1987. But as we have shown, the 1987 rescue operation was a close-run thing, made possible only by the cooperation of the U.S. banks. A successful repetition is far from assured.

Indeed, a fundamental difference between the 1987 and today is the secular decline in the U.S. banking system as a source of liquidity and credit. What makes the role of the banks so vital? Their lending constitutes the *only* process

by which new money – bank deposits – can be created. At the time of the 1987 crash, banks were creating such liquidity in abundance. Between the start of 1985 and the crash, M2 grew by nearly 23%. This ocean of newly created bank liquidity helped fuel the bull market. But when the bubble burst, it also cushioned the blow to the financial system. Once the initial crisis passed, the markets were able to stage a surprisingly quick recovery.

Today, by contrast, underlying liquidity trends are nothing short of catastrophic. If the flight back to cash becomes general, the resulting collapse in asset values could vastly exceed the 1987 experience. In such a situation, the Fed would have no choice but to throw open its discount window to every threatened institution. But even then, the size and speed of the crisis could overwhelm the Fed's ability to respond in time.

A crash or prolonged bear market will have devastating effects on the U.S. economy. We think these also will be beyond the Fed's power to remedy. The best evidence for this can be found in Japan. Since the stock and real-estate crash of 1990, Japanese officials have struggled desperately to reflate the financial system. Yet, despite massive fiscal pump priming and equally massive liquidity injections by the Bank of Japan through its dollar-support operations, the Japanese economy shows only faint flickers of a recovery.

CONCLUSIONS

While world economic conditions have improved, the liquidity conditions underlying the financial markets have deteriorated dramatically – as evidenced by the global bond crash and the substantial declines in global equity prices. As a result, cash was king in 1994. We think it will continue to reign in 1995.

Because prolonged U.S. monetary ease played such a decisive role in fueling the international boom, we think it critical to focus on developments in the U.S. flow of funds. We see a ferocious liquidity squeeze unfolding. This is a result partly of the unwinding of speculative positions, and partly of stagnant U.S. money growth.

Financial markets have been conditioned to expect a soft landing for the U.S. economy. We, on the other hand, believe a hard landing is inevitable. Only the timing remains in question. The economy's two main sources of strength – the consumer borrowing binge and a big bulge in inventories – both are prone to sudden, sharp reversals.

A hard landing for the U.S. economy implies a hard landing for the U.S. dollar. This will add to the liquidity crunch in the financial markets and make it difficult for the Fed to ease again. For investors, our three recommended asset classes remain cash, cash and cash. For dollar-based investors, this means diversification into the liquid short-term securities of the hard currency countries, primarily Germany, Switzerland, Austria, and the Netherlands.

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